In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-650

CHARLES SCHNEIDER & CO., INC., et al.,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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PRIESMAN GRAPHICS – OMAHA, NEBRASKA

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioners* respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in this proceeding on August 19, 1974.

*Petitioners are Charles Schneider & Co., Inc., an Iowa corporation, and Future Foam, Inc., a Nebraska corporation.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 500 F. 2d 148 (1974) and is set forth at Appendix A, infra. The opinion of the Tax Court is reported at 42 T.C.M. 537 (1973) and is set forth at Appendix B, infra.

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit was entered on July 10, 1974. A timely petition for rehearing was denied on August 19, 1974 and this petition for certiorari was filed within that date. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. Para. 1254(1).

QUESTIONS PRESENTED

1. Whether compensation paid by Petitioners to their respective chief executive officers pursuant to and in accordance with duly executed contingent compensation agreements is reasonable and properly deductible under Section 162 of the Internal Revenue Code of 1954, as amended, and the applicable regulation thereto.

2. Where the Petitioners present evidence, including the testimony of expert witnesses upon the issue of reasonable compensation of officers, and none of this testimony is competently controverted or impeached, the issue must be resolved in favor of the Petitioners' contentions.

3. By its interpretation of Treasury Regulation Section 1.162-7, the Court of Appeals, Eighth Circuit, is in conflict with the Court of Claims and the Courts of Appeal in the Fifth, Sixth, Seventh and Ninth Circuits.

STATUTORY PROVISIONS INVOLVED

This case involves Section 162 of the Internal Revenue Code of 1954 and Treasury Regulation Para. 1.162-7, which are set forth at Appendix C1 and C2, respectively.

The case also involves Rule 52(a) of the Federal Rules of Civil Procedure which is set forth at Appendix C3.

STATEMENT OF THE CASE

The taxpayer corporations in the above-entitled cases, which were consolidated in the Tax Court and the Eighth Circuit Court of Appeals are appealing from the decision of the Tax Court and affirmed by the said Court of Appeals, determining deficiency income tax liability against Charles Schneider & Co., Inc. (hereinafter referred to as C.S.&Co.), for the taxable years ending June 30, 1966, 1967 and 1968 in the amounts of $23,512.40, $15,333.42 and $21,721.05, respectively, and determining income tax deficiency against Future Foam, Inc. for the taxable years ending August 31, 1966, 1967 and 1968 in the amounts of $18,130.17, $3,475.46 and $7,365.58, respectively.

Charles Schneider conducted a furniture upholstering business as a sole proprietorship in Omaha, Nebraska, beginning about the year 1946. Later, he moved the business .o Council Bluffs, Iowa and on January 1, 1954, transferred the proprietorship to Petitioner, CS&Co., an Iowa corporation, organized on that date, in exchange for capital stock. Charles Schneider has been and still is the sole shareholder of this corporation. CS & Co. is a manufacturer of upholstered furniture, a highly competitive business, and its sales are made throughout the United States, with its greatest concentration in the midwest market.

During the fiscal years 1962 and 1963, CS & Co. found itself in an extremely unfavorable financial position due to a substantial reduction in its sales volume which suffered a decrease of almost 60%. The management was discouraged and in panic and radical action was required to reverse the impending financial disaster of the Company.

After extensive negotiations between Leon Summer and Charles Schneider, who as sole stockholder was representing CS & Co., Summer was elevated to the office of the corporation's President and he entered into a contingent compensation agreement with the corporation, which provided him with the incentive to remain with the corporation and meet the overwhelming challenge of the crisis. A similar contract was entered into with Charles Schneider.

The agreements that are now under attack existed throughout the years in issue and provided that Schneider would receive a fixed salary of $230 a week and that Summer would receive a fixed salary of $351 per week and, in addition, the contracts provided that they would be paid bonuses based on the productivity of the corporation. These bonuses are computed as follows:

Bonus No. 1 — If there is sufficient net income — three-quarters of one percent of annual net sales were to be divided equally between Schneider and Summer.

Bonus No. 2 — After deductions from net profits for:

(a) Salaries of Schneider and Summer, and the No. 1 bonuses;

(b) Two percent of net sales for retained earnings.

(c) Federal Income Taxes.

(d) State Income Taxes.

The remainder to be divided equally between Schneider and Summer.

Furthermore, Schneider's contract provided that his total compensation from CS & Co. could not exceed $65,000. Summer, a *nonstockholder*, had a provision in his contract that allowed him the right to purchase not more than 20% of CS & Co. common stock, at a price that was double the corporation's book value. Summer's contract also contained a restrictive provision that prevented him from undertaking any business pursuit that was not for the exclusive benefit of CS & Co., unless he first obtained permission in writing from the corporation's Board of Directors.

The unrebutted evidence clearly demonstrates that prior to the execution of these contingent compensation agreements, there were considerable negotiations carried on between Summer and Schneider with the corporation's counsel acting as the go-between and mediator for the two parties, and that Summer had consulted his own private attorney for counsel on several occasions in connection with this matter. Although related through marriage, Summer and Schneider were constant and unrelenting adversaries. The evidence also shows that Summer refused to execute a similar compensation agreement with Central Woodworking Company, an Iowa corporation, in which Summer and Schneider each owned 50% of the outstanding capital stock, because that particular agreement contained certain restrictive convenants which he found objectionable.

Although the contingent compensation agreement gave Summer the option to purchase up to 20% of the corporate stock of CS & Co., *he declined to exercise that option and at no time has he ever owned any stock in the corporation.* Schneider was aware of Summer's value and the evidence reveals that Summer was approached to become chief executive of another furniture manufacturing company which had an annual sales volume that was approximately ten or twelve million dollars. The Internal Revenue Service Examining Agent, who was the only witness presented by Respondent, readily admitted that there wasn't anyone available to replace Summer. In the fiscal year ending the day immediately preceding the day the parties entered into the contingent compensation agreements in question, the net profit (before officers' salaries) of CS & Co. was 2.495% of gross sales. In the years thereafter, including the period in question, Summer was extremely successful in reversing the corporation's financial disaster and dramatically increased its net profit to 4.282% of sales in 1964; 8.669% in 1965; 14.031% in 1966; 13.029% in 1967, and; 11.413% in 1968. During the same period, the total sales of the corporation increased annually as follows: 10% in 1964; 10.7% in 1965; 17.1% in 1966; 22.0% in 1967; and 40.6% in 1968.

In fiscal year 1964, the first operative year of the contingent compensation agreements, Summer's total compensation from CS & Co. was $21,083 and Schneider received $14,570. Thereafter, Summer received $38,329 in 1965; $74,414 in 1966; $66,358 in 1967, and; $74,089 in 1968. After 1964, Schneider received $31,496 in 1965; $65,104 in 1966; $59,052 in 1967 and; $65,000 in 1968.

Although recognizing the "obvious superior talents" of Summer and Schneider, and admitting the uncertainties in substituting its business judgment for that of others, and, after totally ignoring and disregarding Regulation §1.162-7, the Tax Court found that the compensation paid by CS & Co. to Summer and Schneider during the corporation's fiscal years 1966, 1967 and 1968 in excess of $60,000 and $40,000, respectively, was unreasonable and hence not allowable as deductions. The Eighth Circuit Court of Appeals affirmed this decision.

Petitioner, Future Foam, Inc. is a corporation organized under the laws of Nebraska and under the name of Charles Jobbing Company, in September, 1958, with its principal office at Council Bluffs, Iowa. Ten shares of common stock of the corporation at a par value of $1,000 ($100 per share) were issued to Charles Schneider on the date of incorporation and on May 1, 1960, the corporation's name was changed to Future Foam, Inc. In its infant stages, Future Foam, Inc. was involved in a research and development program involving polyurethane plastics.

Schneider initiated the program in 1957 as a Division of CS & Co. by experimenting with the possibility and feasibility of manufacturing polyurethane foam for use in cushioning in upholstered furniture. He enlisted the aid of Dr. D. N. Marquardt, a Professor of Chemistry at the University of Omaha, who had extensive background in the field of organic chemistry, and Bill Grassman, a highly regarded student of Dr. Marquardt's. After his graduation, Mr. Grassman began fulltime employment with the Future Foam division of CS & Co. and his compensation progressed from approximately $5,000 annually in 1958 to between $8,000-$9,000 in 1962. Sol

Friedman began working for the division in late 1958 or early 1959 while attending the University of Omaha. Upon his graduation in 1959 with a bachelor's degree in business administration, he began fulltime employment with the division and his beginning compensation in those years was comparable to Grassman's.

Although Future Foam Division of CS & Co. and Future Foam, Inc. were seriously limited in the development of the polyurethane manufacturing process because of their lack of capital, Grassman and Friedman, under Schneider's directions, made substantial improvements in the industry's method of polyurethane production which made the product economically feasible to produce and market. These individuals were pioneers in the development of an efficient method of pure polyurethane production.

On June 30, 1963, the Future Foam Division of CS & Co. was separated and transferred to Future Foam, Inc. Thereafter, with Charles Schneider as the *sole* stockholder, Future Foam, Inc. commenced its operation as a manufacturer of polyurethane foam products. Friedman became the President of the corporation on July 1, 1963 and on the same date, Grassman was elected Vice President, however, they operated as dual chief executives. On the same date and after a period of extensive negotiations between Friedman, Grassman and Schneider, who represented Future Foam, Inc. as its sole stockholder, contingent compensation agreements between those individuals and the corporation were executed. At the time of the transfer, it was understood Schneider would receive an additional 180 shares of the stock distribution on or about September 1, 1963, and on that date, the stock distribution was

made by Future Foam, Inc. to Schneider, who then owned *all* 190 shares of the corporation's outstanding capital stock at the total par value of $19,000. When these contracts were effected, Future Foam, Inc. was suffering from an extreme lack of capital. This was a very unhealthy condition considering the competitiveness of the foam industry. Future Foam, Inc.'s major competition was provided by some of this nation's largest corporations, such as, B. F. Goodrich, Goodyear Tire & Rubber Co., U.S. Rubber, American Latex and Dayton Rubber Co.

Since Friedman and Grassman desired to achieve monetary benefits in the event the corporation should ever become profitable, and armed with the leverage position they possessed as pioneers in an industry that was still in its infancy stage, they negotiated an agreement with Schneider that resulted in a low base salary with a bonus based on the corporation's performance. From that time, Friedman and Grassman were challenged to survive with monetary returns based on a direct relation to their efforts and success in achieving a high level of productivity for Future Foam, Inc. achieving a high level of productivity for Future Foam, Inc.

The contingent compensation agreements that are now being attacked by the Respondent were entered into by Schneider, Friedman and Grassman with Future Foam, Inc. on July 1, 1963 and were in effect throughout the years in issue. Under the terms of the contract, Schneider was to receive a base salary of $150 per week, and Friedman and Grassman were to each receive base salaries of $175 per week. In addition, the agreements provided, as hereinbefore stated, bonuses to be paid them based on the productivity of the corporation. The bonuses are computed as follows:

Bonus No. 1: If there is sufficient net income — three-fourths of one percent of annual net sales are to be divided equally between Friedman and Grassman.

Bonus No. 2: After deductions from net profits for:

(a) Salaries of Schneider, Friedman and Grassman and the No. 1 bonuses.

(b) Two percent of net sales for retained earnings.

(c) Federal income taxes.

(d) State income taxes.

The remainder to be divided equally between Schneider, Friedman and Grassman.

Schneider's contract further provided that his total annual compensation (base salary plus productivity bonus) would not exceed $65,000, however, at a special meeting of the Board of Directors of Future Foam, Inc. held on November 5, 1965, Schneider's maximum total annual compensation was reduced to $45,000 per year for the fiscal year beginning September 1, 1965. Friedman's and Grassman's contracts contained provisions restricting their outside business activities and allowed each of them the opportunity to purchase not more than 20% of the issued and outstanding capital stock of Future Foam, Inc. The contracts also provided that Friedman and Grassman would have no interest in Future Foam's wholly owned subsidiary, Charles, Inc., and that the net stockholders' equity in that company would accrue only to Schneider.

Friedman and Grassman did not exercise their stock options *until February 15, 1965,* at which time, they each acquired 23.75 shares of common stock for $4,156.25. On August 31, 1965, they each acquired an additional 39.58 shares

of stock for $6,926.50. From that time, including the years in issue, Schneider owned a majority interest of 60% of the issued and outstanding capital stock of Future Foam, Inc. and Friedman and Grassman each owned 20% in accordance with their contract.

In the fiscal year ending the day immediately preceding the day the parties entered into the contingent compensation agreements, the net profit (before officers' salaries) of Future Foam, Inc. was $15,771 which represented *1.312%* of gross sales. In the years thereafter, including the period in question, Friedman and Grassman (who the Examining Revenue Agent admitted could not be replaced by anyone available) with Schneider's guidance, were incredibly successful in increasing the corporation's net profit as follows:

Year	Net Profit Before Officer's Salaries	Net Profit (before Officers Salaries) expressed as percentage of sales.
1964	$ 74,529	8.249%
1965	238,017	19.671%
1966	265,995	20.570%
1967	125,883	9.478%
1968	132,064	8.201%

During the same period, the total sales of Future Foam, Inc. grew annually from a negative 24.9% in 1964 to an increase of 33.9% in 1965, 6.9% in 1966, 2.7% in 1968 and 21.2% in 1969.

In fiscal year 1964, the first operative year of contingent compensation agreements, the total compensation paid by Future Foam, Inc. to Grassman and Friedman was $21,512 each and Schneider received $6,023. Thereafter, Grassman and

Friedman each received $70,399 in 1965; $80,176 in 1966; *$31,874* in 1967, and; *$30,874* in 1968. Schneider received $60,117 in 1965; $45,000 in 1966; $45,780 in 1967, and; *$19,086* in 1968.

Although admitting the uncertainties of substituting its business judgment for that of others, the Tax Court found and the Eighth Circuit Court of Appeals upheld that the Compensation paid by Future Foam, Inc. to Friedman, Grassman and Schneider during the corporation's fiscal year 1966 in excess of $65,000 for Friedman and Grassman and $40,000, to be excessive and hence unallowable as deductions. The respondent did not attack the amount of compensation paid these individuals in 1967 and 1968, when their contracts allowed them less than one-half of the compensation received in the year under attack.

REASONS FOR GRANTING THE WRIT

Introduction

Paragraph Section 162(a)(1) of the Internal Revenue Code of 1954, as amended, limits the deduction claimed for salary and wage payments to a "reasonable allowance" for personal services actually rendered. Where, as here, compensation for personal services is paid pursuant to and in accordance with a contingent compensation agreement, Internal Revenue Code Regulation, Section 1.162-7(a) is applicable. The Regulation provides:

> Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing the services of the

> individual, *it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.* (Emphasis added.)

Section 1.162-7(3) of the Regulations adds an overview most pertinent to the instant case:

> The circumstances to be taken into consideration *are those existing at the date when the contract for services was made,* not those existing at the date the contract is questioned.

While the controlling nature of the quoted regulatory provision is apparent and its patent application to the facts at bar is unequivocal, its absence from the opinion of the Tax Court serves to emphasize the clearly erroneous standard of law applied in this case, *Coast Quality Construction Corp. v. United States,* 463 F. 2d 503 (5th Cir. 1972); *Lewis v. Super Value Stores, Inc.,* 364 F. 2d 555 (8th Cir. 1966); *Baker v. United States,* 343 F. 2d 222 (8th Cir. 1965); *Cole v. Neaf,* 334 F. 2d 326 (8th Cir. 1964); *United Artist Television, Inc. v. Fortnightly Corporation,* 377 F. 2d 872 (2nd Cir. 1967), Rev. 88 S. Ct. 2084, 392 U.S. 390, 20 L. Ed. 2d 1176 reh. den. 89 S. Ct. 65, 393 U.S. 902, 21 L. Ed. 2d 190; *Jefferson Memorial Gardens, Inc. v. Commissioner of Internal Revenue,* 390 F. 2d 161 (5th Cir. 1968) reh. den.; *Herbert v. Commissioner of Internal Revenue,* 377 F. 2d 65 (9th Cir. 1966) reh. den.; *Fed. R. Civ. P.,* Rule 52 (a), 28 U.S.C.A.

The guidelines set forth in the Regulations issued in pursuance of Section 1.162 of the Internal Revenue Code are dispositive of the issue herein. As stated in *Commissioner of Internal Revenue v. Duberstein,* 363 U.S. 268, 4 L. Ed. 1218, 80 S. Ct. 1190 (1960):

> A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed. *United States v. United States Gypsum Co.*, 333 U.S. 364, 395, 92 L. Ed. 746, 766, 68 S. Ct. 525. The rule itself applies to factual inferences from undisputed basic facts, i.b., 333 U.S. at 394, as will on many occasions be presented in this area — (at p. 1228)
>
> —There comes a point where findings become so sparse and conclusory as to give no revelation of what the district courts concept of the determining facts and legal standards may be. (At p. 1229.)

1. The decision below affirms a conclusion of fact that was not made by the Tax Court. The absence of such factual determination resulted from the Tax Court not applying the proper legal principle in the determination of these cases.

The overwhelming case law authority explicitly demonstrates that to determine whether or not compensation paid pursuant to a contingent compensation agreement is reasonable, such an agreement must be judged by the facts and circumstances existing at the time the contract was entered into. If such an agreement is thus determined to be reasonable when entered into and was the result of an arm's length transaction, then the compensation thereafter paid pursuant to the contingent compensation agreement terms must be determined to be reasonable, *Robert Rogers, Inc. v. United States*, 50-2 USTC, Para. 9510, 118 Ct. Cl. 126, 93 F. Supp. 1014 (1950); *J. D. Van Hooser & Co. v. Glenn*, 50 F. Supp. 279 (W.D. Ky. 1943); *James J. McHale Co. v. United States*, 151 F. Supp. 115 (D.C.N.D. Ohio 1957); *Miller Box, Inc. v. United States*, 488 F. 2d 695 (5th Cir. 1974). In the case at bar it was

only when the Petitioners were deriving profits and operating at an efficiency far in excess of the industry trends, and when concomitantly, the compensation of their chief executive officers was consequently higher due to their own efforts, did the government choose to assail the contingent compensation agreements in question. Hindsight is not a standard found in Treasury Regulation §1.162-7. The subject agreements were reasonable when executed in 1963 and are, therefore, reasonable for the period under review.

In affirming the Tax Court's decision, the Court of Appeals, Eighth Circuit, stated at page 158 of its opinion that "other evidence exists which supports the Tax Court's conclusion that these agreements were not the result of arm's length bargaining . . ."

Petitioners respectfully submit that the lower court affirmed a conclusion of fact supposedly made by the Tax Court which the Tax Court did not make. Not once in the opinion of the Tax Court do the words "arm's length transaction" or "free bargain" appear. The Tax Court completely ignored the controlling Treasury Regulation §1.162-7 and based its decision on standards of law not applicable to a case of this nature, thereby rendering a decision that was totally arbitrary and capricious. Because of the Tax Court's failure to properly decide the case under the proper standard of law, it did not concern itself with the question of "arm's length transaction" or "free bargain." The purpose of the appeal to the lower court was to correct the aforementioned error of law.

The lower court emphasizes the relationship of Schneider and Summer, who are brothers-in-law by marriage, and

Schneider and Friedman, who is a cousin to Schneider's wife, as demonstrative of the lack of an arm's length agreement. However, the record shows that Summer and Schneider were constant and unrelenting adversaries. The clear, unequivocable and uncontroverted testimony demonstrates that prior to the finalization of the contingent compensation agreements in issue, there were considerable negotiations carried on between Summer and Schneider, with the corporation's counsel acting as the go-between and mediator for the two parties, and that Summer had consulted his own private attorney for counsel on several occasions in connection with the agreement in quesiton. The evidence also shows that Summer refused to execute a compensation agreement with Central Woodworking Company, a corporation in which he and Schneider each owned fifty percent of the outstanding capital stock, because that particular agreement contains certain restrictive provisions that were unacceptable to him. The record shows that there are few men with Summer's credentials. He was an experienced businessman by the time his contingent compensation agreement was executed and had graduated from the City College of New York with cum laude honors; was elected to Phi Beta Kappa; undertook graduate work at Columbia University, and; completed all of the required courses for a Master's Degree in Economics with the exception of the final thesis. Interestingly enough, the Internal Revenue Service Examining Agent, who was the only witness presented by Respondent, readily admitted that there wasn't anyone available to replace Summer and the Tax Court recognized Summer as a man with "obvious superior talents."

Based on the financial records of CS & Co. for the years prior to 1963, Schneider negotiated well for his corporation.

Had the same contingent compensation agreements been in existence prior to 1963, the sales and profits of CS & Co. in those prior years would not have been sufficient to cause the second level bonus contained in the contingent compensation agreements to become operative. In fact, in 1961, without any contingent compensation agreements in existence, the amount retained by CS & Co. was an amount equal to 1% of sales; ½ of 1% of sales was retained in 1962, and in 1963, a period which included the negotiations on the agreements now under attack, the amount retained was .0003142% of sales. In order for the second level bonus in the subject agreements with CS & Co. to become operative, the corporation would have had to do twice as well as it did in 1961, four times better in 1962 and infinitely better in 1963.

The clear, unequivocal and uncontroverted testimony also clearly demonstrates that prior to the finalization of Future Foam's contingent compensation agreements, there were considerable negotiations carried on between Grassman, Friedman and Schneider, representing Future Foam, Inc. It is undisputed that Friedman, Grassman and Schneider were pioneers in an industry that was starting from scratch. It is undisputed that Grassman was employed at approximately the same time as Friedman and was a party to the same contingent compensation agreement. It is also undisputed that Grassman is in no way related to Schneider, Friedman, Summer or any of their relatives. The same Internal Revenue Service Examining Agent also admitted that Friedman, as well as Grassman, could not be replaced by anyone available. The lower court wishes to penalize Summer and Friedman for their being remote relatives to Schneider. Although unrelated, Grassman is consigned to suffer the same penalty. Petitioners respectfully submit that in

light of the facts and circumstances existing in 1963, the relationship in now way affected the terms and provisions of these agreements. The fact that Summer and Friedman are related to Schneider through marriage has no bearing on their value to their employer. Nepotism does not guaranty job performance and job performance is the essence of contingent compensation agreements. *Express Publishing Co. v. Commissioner of Internal Revenue*, 143 F. 2d 386 (5th Cir. 1944), an appellate decision reversing the Tax Court.

The Court of Appeals stated that because these men were stockholders, their agreements were not the result of arm's length bargaining, but were in reality a mechanism for the distribution of profits. However, the Court failed to note that when these contracts were executed in 1963, only Schneider was a shareholder of these Petitioners. It was Schneider who negotiated these contracts on behalf of the Petitioners. Summer was a minority member of the Board of Directors of his employer and Friedman and Grassman did not become members of the Board of Directors of their employers until after the contingent compensation agreements were signed. It was not until 1965 that Friedman and Grassman exercised their stock options in Future Foam, Inc.

It should also be underscored that while Schneider could not make an arm's length compensation agreement with his employer because of his control, the fact that the transactions with the other executives must be considered arm's length transactions, his contingent compensation agreements should be similarly regarded because they parallel the contingent arrangements with the "outsider" executives with the exception that they received larger compensation than he permitted himself to earn.

It is important to note that there is no close relationship, if any, between the ratio that the compensation of these chief executives bears to their stock ownership of the Petitioners, *Mayson Manufacturing Company v. Commissioner of Internal Revenue*, 178 F. 2d 115 (6th Cir. 1949). In fact, Summer would be unable to participate in any dividend distribution of his employer because he does not own any of its stock. Even after Friedman and Grassman exercised their stock options the compensation they received bore no relationship to their stockholdings, *Mayson Mfg. Co. v. Commissioner of Internal Revenue*, supra. Petitioners respectfully submit that there is no relationship to the compensation paid under any of the contingent compensation agreements to that of the stockholdings of the recipients receiving compensation thereunder, and, therefore, such compensation paid cannot be considered to be a dividend.

Profits do not flow to furniture manufacturers or polyurethane foam producers as a result of routine manufacturing and sales procedures. Responsible management remains the key to success of such business and the managerial responsibility of the Petitioners herein has been placed in their chief executive officers. The large profits of the Petitioners in the taxable years were made possible to a large extent by the efforts expended by each of their chief executives in prior and less profitable years. See *California Vegetable Concentrates, Inc. v. Commissioner of Internal Revenue*, 10 T.C. 1158 (1948). In the present case, each of the Petitioners' chief executives was an experienced, highly qualified and exceptionally able person. Each performed their functions in an extraordinarily successful manner and sacrificed unlimited time and effort in meeting the increased duties, responsibilities, problems and demands of the Petitioners' business operations.

In terms of rate of growth, each Petitioner herein has far out performed its respective industry. By challenging the Petitioners' contingent compensation agreements, Respondent is, in effect, advancing the idea that a low risk and a low reward is acceptable; that a high risk and a low reward is also acceptable; however, to have a high risk and a high reward is anathema.

It is submitted that the lower compensation payments made by Petitioners to their chief executives in the early years of their compensation agreements prove, rather than vitiate, the validity of the higher remuneration in the years following. The early years of the agreement represent, in this instance, the risk and the later years represent the reward. It is worth emphasizing that the Petitioners herein would not be petitioners if their chief executives had not been so successful in the operation of their businesses. As the court so succinctly stated when discussing contingent agreements in *James M. McHale Co. v. United States*, supra, "mere success does not make them illegal."

To limit the top management incentive through the destruction of the sanctity of contract would be an effective method of destroying these Petitioners. How can small companies such as the Petitioners compete with large companies in obtaining and retaining talented executives if they cannot offer high salaries and lucrative fringe benefit programs without the guarantee of superior performance. The answer is provided them through the use of contingent compensation agreements, which are allowable by virtue of Treasury Regulation §1.162-7. The elimination of self-motivating forces that contingent compensation agreements provide will, as our

economy has vividly demonstrated, depress or eliminate the Petitioners' goals for increased productivity, in theory and in practice. As the court in *Roth Office Equipment v. Gallagher*, 172 F. 2d 452 (6th Cir. 1949), noted:

> If the principle of bonus compensation is to be recognized, it carries with it the payment of liberal compensation in good years and moderate compensation in bad years. (At 120.)

While the government is now seeking to encourage and expand sales, to increase productivity, to stimulate markets for export, it is at the same time seeking to destroy closely held companies who are compelled to compete with national and international industrial giants, who carry on their business with Treasury Department blessings.

2. Where the Petitioners present evidence including testimony of expert witnesses upon the issue of reasonable compensation of officers, and none of this testimony is competently controverted or impeached, the issue must be resolved in favor of the Petitioners' contentions.

It is an acknowledged principle of jurisprudence that the action of a Board of Directors of a corporation in voting salaries is entitled to the presumption that such salaries are reasonable and proper, *Ox Fibre Brush Co. v. Blair*, 32 F. 2d 42; 68 A.L.R. 696 (4th Cir. 1929); *Toledo Grain and Milling Co. v. Commissioner of Internal Revenue*, 62 F. 2d 171 (6th Cir. 1932); *Capitol-Barg Dry Cleaning Co. v. Commissioner of Internal Revenue*, 131 F. 2d 712 (6th Cir. 1942).

In *Mayson Mfg. Co. v. Commissioner of Internal Revenue*, supra, the Court stated (at p. 121):

> This is another case similar to others . . . where all testimony before the Tax Court was on behalf of the petitioner. The Commissioner introduced no witness in his behalf. No witness testified that the compensation fixed by the Tax Court for each of the three officers was, in fact, reasonable compensation for the services rendered . . . On the contrary, petitioner's testimony was that the compensation actually paid was reasonable compensation in each instance . . . If the compensation received . . . was unreasonable for the services rendered, certainly the government could have produced some experienced witnesses . . . who would have said so. The lack of such evidence operates very strongly against the defendant's contention.

In *Roth Office Equipment Co. v. Gallagher*, supra, the success of the company over the period of years in which the contested employees' salaries were an issue was given great weight. Again, in determining the issue as one going to the burden of going forward with the evidence, it was said:

> The appellee offered no witnesses in support of his position. No witness testified that the amounts found by the District Court as reasonable compensation in 1942 was the reasonable compensation to which the officers were entitled. The only direct evidence before the court on the specific question of reasonableness of compensation was the testimony . . . of well qualified, impartial witnesses with many years of experience. They testified that, in their opinion, the compensation was reasonable . . . The appellee offered no witness to contradict this testimony or to testify in any way that the compensation was reasonable . . . The appellee offered no witness to contradict this testimony or to testify in any way that the compensation

> was unreasonable to any extent. On this crucial and single issue of fact in this case, this unimpeached, uncontradicted testimony from well qualified impartial witnesses cannot be disregarded by the court. (At p. 455.)

In *J. D. Van Hooser & Co. v. Glenn*, supra, the Court in discussing the testimony of the plaintiff and the testimony of the two expert witnesses offered by the plaintiff, said:

> The government permitted this evidence to go uncontradicted. Certainly, if the opinion of these two witnesses did not reflect the consensus of practical experience men in the same line of business in this community, the government would have had no difficulty in offering testimony to the contrary. (At p. 286.)

Petitioners submit that the only testimony offered concerning the unreasonableness of the compensation paid to Petitioners' respective chief executives under their contingent compensation agreements was that of an Internal Revenue Service agent who had never before examined a company engaged in the manufacture of upholstered furniture or polyurethane foam that had sales in excess of one million dollars. Furthermore, the agent testified that each of the Petitioners herein were extremely "fortunate in having very competent people" as the corporate leaders and he readily admitted that there was no one available to replace any one of them.

Petitioners have presented evidence by virtue of the testimony of a reputable furniture sales representative employed by a competitor of Petitioners after being employed by CS & Co., one of the Petitioners herein. Petitioners have presented the expert testimony of Mr. Graef Crystal, a man

nationally recognized in the field of executive compensation, who not only possessed knowledge concerning the general view of executive compensation and contingent arrangements, but who also had special knowledge peculiar to the compensation paid to executives of furniture and polyurethane manufacturers of comparable size to the Petitioners. Moreover, Petitioners presented Mr. Frank S. Whiting, the President and Director of the largest furniture market in the world who also served as a furniture manufacturing industry consultant to the government of the United States. It was the conclusion of these experts that the compensation paid by the Petitioners to their chief executive officers was reasonable.

3. By its interpretation of Treasury Regulation Section 1.162-7 the Court of Appeals, Eighth Circuit, is in conflict with the Court of Claims and the Court of Appeal in the Fifth, Sixth, Seventh and Ninth Circuits.

This petition presents an important question of interpretation of Treasury Regulation §1.162-7. On page 152 of its opinion the lower court cites Regulation 1.162-7 as follows:

> (2) The form or method of fixing compensation is not decisive as to deductibility . . . generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

> (3) . . . The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

The Court then states:

> However, Treasury Regulation §1.162-7 (a) (3) limits this by providing that '*in any event the allowance of the compensation paid may not exceed what is reasonable under all the circumstances.* It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances.' Thus, even if the conditions of Section 1.162-7(a) (2) are met, a fact finder could still find a contingent compensation agreement to be unreasonable under all the facts and circumstances of a particular case . . . (Emphasis added.)

Petitioners respectfully submit that Treasury Regulation Section 1.162-7 (a) (3) reads as follows:

> In any event the allowance for the compensation paid may not exceed what is reasonable under all the *circumstances.* It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like circumstances of like enterprises under like circumstances. *The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.* (Emphasis added.)

By virtue of the lower court's juxtaposition of the key language contained therein, the Court has changed the meaning of 1.162-7. In effect, the lower court has taken the position that even if compensation paid under a contingent compensation agreement is reasonable when such agreement is executed, it

may later become unreasonable because the compensation paid under, may at a subsequent time, exceed what is reasonable under all circumstances at such subsequent time. Petitioners submit that under the aforementioned Treasury Regulation the test of whether or not compensation paid under a contingent compensation agreement is reasonable is to be determined by the facts and circumstances existing at the time such agreement was made and not at a subsequent date, *Robert Rogers v. United States*, 50-a U.S.T.C. Sec. 9510, 118 Ct. Cl. 126, 93 F. Supp. 1014 (1950); *Miller Box, Inc. v. United States*, 488 F. 2d 695 (5th Cir. 1974); *Austin et al v. United States*, 28 F. 2d 677 (5th Cir. 1928); *Roth Office Equipment v. Gallagher*, 172 F. 2d 452 (6th Cir. 1949); *Mayson Mfg. Co. v. Commissioner of Internal Revenue*, 178 F. 2d 115 (6th Cir. 1949); *Hammond Lead Products, Inc.*, Sec. 69.014 P-H Memo, TC 69-57 (1969) aff'd; *Hammond Lead Products, Inc. v. Commissioner of Internal Revenue*, 425 F. 2d 31 (7th Cir. 1970); *James J. McHale Co. v. United States*, 151 F. Supp. 115 (D.C.N.D. Ohio 1957); *Harold's Club v. Commissioner of Internal Revenue*, 15 AFTR 2d 241, 340 F. 2d 861 (9th Cir. 1965); *Hoffman Radio Corporation*, Para. 48, 138 P-H Memo, TC 48-379 (1948), aff'd. *Hoffman Radio Corporation v. Commissioner of Internal Revenue*, 177 F. 2d 264 (9th Cir. 1949).

CONCLUSION

For the above reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Opinion of the United States Court of Appeals — Eighth Circuit

Submitted: May 13, 1974

Filed: July 10, 1974

Before JOHNSEN and VAN OOSTERHOUT, Senior Circuit Judges, and TALBOT SMITH, Senior District Judge.*

VAN OOSTERHOUT, Senior Circuit Judge.

The taxpayer corporations in the above-entitled cases, which were consolidated in the Tax Court and here, have taken timely appeals from the decision of the Tax Court determining deficiency income tax liability against Charles Schneider & Co., Inc. (C.S. & Co.), for the taxable years ending June 30, 1966, 1967 and 1968, in the amounts of $23,512.40, $15,333.42 and $21,721.05 respectively, and determining income tax deficiency against Future Foam, Inc., for the taxable years ending August 31, 1966, 1967 and 1968, in the amounts of $18,130.17, $3,475.46 and $7,365.58 respectively. The Tax Court's opinion filed June 18, 1973 is reported at 32 TCM 553 (1973). Decision was entered in accordance with the opinion on August 22, 1973. This appeal followed.

Many issues involved in this litigation have been resolved and are no longer in controversy. Taxpayers in their brief challenge the Tax Court's determination that under the facts of this case Charles, Inc., was not entitled to file a consolidated return with its subsidiary Chemical Corporation of America.

*TALBOT SMITH, Senior District Judge, Eastern District of Michigan, sitting by designation.

Such issue was specifically abandoned by taxpayers on oral argument. In any event, the decision of the Tax Court on the issue is entitled to be affirmed on the basis of the Tax Court's opinion.

The issue before us is whether taxpayers C.S. & Co. and Future Foam, Inc., are entitled to ordinary and necessary business expense deductions under §162(a)(1) I.R.C. 1954 for the compensation paid their chief executive officers for the years ending in 1966, 1967 and 1968, in excess of the amount which the Tax Court found to be reasonable compensation for services rendered to the corporations.[1] More specifically, the issue is whether the Tax Court's determination of the amount of executive compensation paid by C.S. & Co. and Future Foam, Inc., which is deductible as a reasonable expense, is clearly erroneous. We hold that the Tax Court's decision is supported by substantial evidence and is not clearly erroneous and affirm the judgment.

The record in this case is long. Much of the evidence is stipulated. Evidence was offered in the Tax Court by both parties. Many exhibits were received in evidence. The pertinent evidence is fairly set out in considerable detail in the Tax Court's opinion. An attempt to set out all of the facts would unduly prolong this opinion. We shall briefly summarize the basic facts. Taxpayers C.S. & Co., Future Foam, Inc., Charles, Inc., and Central Woodworking Co., Inc., are all active in various aspects of the furniture and upholstering manufacturing business at Council Bluffs, Iowa. Charles Schneider played the principal part in organizing and

[1] The Tax Court determined as a deductible business expense all executive compensation paid by Charles, Inc., and Central Woodworking Co., Inc., and such determination is not here challenged.

developing such corporations. His efforts contributed significantly to the successful operation of the corporations. During the tax years here in controversy all of the stock in C.S. & Co., 60% of the stock in Future Foam, Inc., 50% of the stock in Central Woodworking Co., Inc., and possibly all of the stock in Charles, Inc.,[2] was owned by Charles Schneider. Schneider, after substantially completing a law school course and serving in World War II, started a furniture and upholstery business about 1946. In 1954 this business was incorporated as C.S. & Co. with Schneider as president and his brother-in-law, Leon Summer, as vice-president. Summer became president in 1963 and assumed active management. Summer had an option to purchase C.S. & Co. stock which he never exercised. Schneider at all times owned all of the corporate stock and maintained an active roll in the company's affairs. In 1963 an agreement was entered into providing a basic salary of $351.00 per week for Summer and $230.00 per week for Schneider, plus bonuses to be computed as follows:

Bonus No. 1.

If there was sufficient net income

Three-fourths of 1% of annual net sales divided equally between Schneider and Summer.

Bonus No. 2.

After deductions from net profits for:

(a) Schneider's and Summer's salaries and No. 1 bonuses.

(b) 2% of net sales for retained earnings;

2Future Foam held legal title to all of the stock of Charles, Inc. Agreements between Schneider and the minority stockholders of Future Foam provided that the minority stockholders acquired no interest in Charles, Inc. No adjudication of ownership of Charles, Inc., stock is essential for the disposition of this case.

(c) federal income taxes;

(d) state income taxes;

remainder to be divided equally between Schneider and Summer.

The amount of compensation paid by C.S. & Co. based on basic salaries and bonuses No. 1 and No. 2 for the fiscal years ending in 1966, 1967 and 1968 was $65,104.94 159,052.98 and $65,000.00 to Schneider and $74,414.50, $66,357.95 and $74,089.36 to Summer. Bonus No., 2 provided the major portion of the compensation paid to the executives. It is undisputed that C.S. & Co. has never paid a dividend. With respect to each of the taxable years here involved, the Commissioner disallowed deductions to C.S. & Co. for compensation paid Schneider in excess of $35,000 and for compensation paid Summer in excess of $50,000. The Tax Court found and determined that for each of the years involved salaries paid by C.S. & Co. to Schneider in excess of $40,000 and to Summer in excess of $60,000 would be unreasonable and hence not allowable as a business expense deduction.

Future Foam was organized by Schneider who held all of its stock until 1965 when he sold 20% of the stock to Grassman and a similar amount to Friedman, all pursuant to a stock option. Grassman and Friedman had been with Future Foam since about 1960 and had put in long hours and capable services in building up the company. Grassman played a major part in developing a successful foam which the company manufactured and sold. Friedman was president of the company and Grassman was vice-president. In 1963 an agreement was entered into to pay Schneider a basic salary of $150.00 per week and Grassman and Friedman each $175.00

per week. Additionally, under Bonus No. 1 Friedman and Grassman were to divide ¼ of 1% of net sales. Bonus No. 2 was in substance the same as the C.S. & Co. Bonus No. 2 with division to be made equally among Schneider, Friedman and Grassman.

Pursuant to this arrangement for the fiscal year ending August 31, 1966, Friedman and Grassman each received compensation of $80,176.00 ($61,807.00 of which was based on Bonus No. 2), and Schneider received $45,000.00. Schneider received $45,780.00 in the fiscal year 1967. The Commissioner disallowed Future Foam a deduction for compensation paid Grassman and Friedman in excess of $50,000 during the fiscal year ending August 31, 1966, and compensation paid Schneider for the fiscal years 1966 and 1967 in excess of $35,000.00 per year. The Tax Court raised the allowable deduction for compensation paid Grassman and Friedman to $65,000.00 and raised the allowable deduction for salary paid Schneider to $40,000.00 for the years 1966 and 1967.

Section 162(a)(1) of the Internal Revenue Code of 1954 permits a taxpayer to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered" as ordinary and necessary business expenses. The determination of what is reasonable compensation is a factual one to be ascertained from all the facts and circumstances of a case, to which the clearly erroneous standard applies, *Charles McCandless Tile Serv. v. United States*, 422 F. 2d 1336, 1338 (Ct. Cl. 1970); *Pacific Grains, Inc. v. Comissioner*, 399 F. 2d 603, 605 (9th Cir. 1968). Decisions of the Tax Court are reviewable in the same manner and to the same extent as decisions of the district courts sitting in civil actions without a jury. This court is bound by the factual determinations of the

Tax Court unless they are found to be clearly erroneous or are unsupported by substantial evidence upon the record as a whole. 26 U.S.C. §7482(a); *Commissioner v. Duberstein*, 363 U.S. 278, 290-291 (1960); *Byrne v. Commissioner*, 449 F. 2d 759, 760 (8th Cir. 1971); *Commissioner v. Riss*, 374 F. 2d 161, 166 (8th Cir. 1967).

Several factors to be considered in determining reasonableness of compensation have been mentioned by the courts.

> Such factors include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years. *Mayson Mfg. Co. v. Commissioner*, 178 F. 2d 115, 119 (6th Cir. 1949).

See also Hammond Lead Products, Inc. v. Commissioner, 425 F. 2d 31, 33 (7th Cir. 1970), quoting 4A Mertens, Law of Federal Income Taxation, §25.69 at 282 (1966); *Irby Constr. Co. v. United States*, 290 F. 2d 824, 826 (Ct. Cl. 1961).

In the instant case, the petitioners strenuously advocate that because the compensation paid to their employees was paid pursuant to contingent compensation agreements, the reasonableness of which must be measured by conditions existing at the time of their execution, the compensation must

necessarily have been reasonable. Such agreements were incentives to the officers to increase the profits, as shown by the later success of these companies. Thus, the payments were reasonable compensation to reward these executives for the successful operation of their respective companies. Support for their position may be found in the language of the regulations. Treasury Regulation §1.162-7(a) provides:

> * * *
>
> (2) The form or method of fixing compensation is not decisive as to deductibility . . . Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.
>
> (3) . . . The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

However, Treasury Regulation §1.162-7(a)(3) limits this by providing that "[i]n any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Thus, even if the conditions of §1.162-7(a)(2) are met, a fact finder could still find a contingent compensation agreement to be unreasonable under all the facts

and circumstances of a particular case; compensation paid pursuant to such an agreement is not inherently reasonable.

Generally speaking, the fact that compensation is based on a contingent compensation agreement, if fixed pursuant to a free bargain, is an element tending to show reasonableness. *Bank of Palm Beach v. United States*, 475 F. 2d 1343, 1348 (Ct. Cl. 1973); *Irby Constr., supra*, at 827. However, where the corporation is controlled by the very employees to whom the compensation is paid, special scrutiny must be given to such salaries, for there is a lack of arm's length bargaining as required by Treasury Regulation §1.162-7(a)(2), *Hammond Products, supra*, at 33; *Heil Beauty Supplies, Inc. v. Commissioner*, 199 F. 2d 193, 194 (8th Cir. 1952), 902 (June 1, 1964). *Cf. Miller Box Co. v. United States*, 488 F. 2d 695, 707 (5th Cir. 1974). In these circumstances payments under these arrangements may be distributions of earnings rather than payments of compensation for services rendered; even if they are reasonable, they would not be deductible, *Irby Constr., supra*, at 827. A bonus-type contract which is reasonable with a non-stockholder employee may be unreasonable if made with a large stockholder, since the incentive of the bonus would presumably not be needed to call forth the stockholder's best efforts, *Id.; Northlich, Stolley, Inc. v. United States*, 368 F. 2d 272, 278 (Ct. Cl. 1966). *See Hampton Corp. supra*, at 902.

In the instant cases, at the time these agreements were entered into, Schneider was the sole shareholder of C.S. & Co. and Future Foam. No special incentive was necessary to ensure his best efforts, for he would receive the fruits of success through his status as the majority shareholder of each of these companies. As the controlling shareholder and director, any

agreement between one of these corporations and him in his status as an employee could not be at arm's length. Summer, while owning no stock, was a member of the board of directors of C.S. & Co., and was a close relative of Schneider, factors tending to show a lack of arm's length bargaining. He held a stock option at the time these agreements were fashioned and throughout the years in question. The ability to exercise this option at anytime would enable Summer to share in the fruits of success of C.S. & Co. as a shareholder at his will, and the agreement in question was similarly not necessary to ensure his continued best efforts. Moreover, it is reasonable to infer that Summer as chief executive officer was awarded generous compensation to make Schneider's compensation appear reasonable. Friedman and Grassman each had the option to purchase 20% of the shares of Future Foam, which options they exercised in 1965. Thus, they too knew they could share in any profits as shareholders, and the contingent compensation plans were not necessary to ensure their best efforts on behalf of the corporation. These individuals with Schneider have been members of the board of directors of Future Foam since prior to the date their compensation agreements were effective, which fact would tend to negate an arm's length bargaining situation. In short, even though the compensation paid to each of these insiders was based on the contingency of profits, this fact alone does not necessarily require a finding under §1.162-7(a) of reasonableness, especially when as here there is evidence of a lack of arm's length bargaining for the agreements.

Other evidence exists which supports the Tax Court's conclusion that these agreements were not the result of arm's length bargaining but were in reality a mechanism for the distribution of profits "apparently without relation to the

services performed." Perhaps most important is the fact that no dividends were ever paid by any of these companies during this time, even though they enjoyed consistent profits and immense success in the industry. A substantial return of investment for the shareholders would be expected from such successful operations. *McCandless, supra,* at 1340. An absence of profits paid back to the shareholders as dividends justifies an inference that some of the purported compensation really represents a distribution of profits. *Id.; Jones Bros. Bakery, Inc. v. United States,* 411 F. 2d 1282, 1293 (Ct. Cl. 1969); *Pacific Grains, supra,* at 60[illegible].

The provisions of the agreements themselves tend to support the notion that they provided for a distribution of profits rather than compensation for services rendered. Under the agreements the officers of each of the companies equally divide the net profits of the companies where they worked after setting aside but 2% of the net sales for retained earnings and necessary amounts for state and federal taxes. These arrangements *necessarily* left little or nothing to be paid as dividends, even if the companies should become profitable (as they did), and may be seen as vehicles for distributing future profits, even though they were entered into at a time when the companies were not in healthy financial situations. The petitioner Future Foam points to a $45,000 per annum limitation on Schneider's salary to show reasonableness. However, an excess bonus of $24,600 in 1966 was simply paid the following year, negating the effect of the limitation.

Other evidence supporting the Tax Court's determinations and conclusions include the fact that Schneider spent less time after 1963 working for each of these petitioners, although the

salary paid him by each increased dramatically. During the tax years here involved, Schneider felt that he had developed competent management teams in C.S. & Co. and Future Foam and was devoting his principal attention to Charles, Inc., in building up a management team. Schneider's total compensation from Charles, Inc., during the years here involved never exceeded $20,000. Summer also spent much time at Central Woodworking, of which he was one-half owner, detracting from the time he devoted to C.S. & Co. The part-time nature of their work are elements which must be considered in determining the reasonableness of their compensation. As pointed out by the Tax Court, other members of the management team at C.S. & Co. and Future Foam did not have similar bonus arrangements to ensure their best efforts.

As pointed out by the Tax Court in its opinion, Schneider had received a total compensation from the four taxpayers aggregating $132,000, $127,000 and $108,000 in the fiscal years ending 1966, 1967 and 1968 respectively. In addition, the factory buildings used by the corporations were leased from Cynthia Realty, of which Schneider was the sole stockholder.

A most significant factor to be considered is a comparison of the compensation under consideration and the prevailing rates of compensation paid to those in similar positions in comparable companies within the same industry. *Jones Bros., supra,* at 1291. The Commissioner introduced evidence showing that the compensation paid by the petitioners were grossly disproportionate to the rates of compensation paid to executives in similar sized companies in the furniture industry, and approached the levels of compensation paid by much

larger companies. The percentage of net profits paid by the petitioners in executive compensation during these years was two to three times the percentages paid in the rest of the industry. The Tax Court compared the compensation practices and levels of the petitioners to those of Charles, Inc., another company within the same controlled group but in direct competition with at least C.S. & Co. Charles, Inc., did not have a bonus No. 2 plan such as was in effect for C.S. & Co. and Future Foam; contingent compensation agreements at this company provided for executive bonuses of only 3.5 to 6.5% of sales, though it was run by Schneider under a similar management philosophy. The evidence showed much lower salaries paid to the executives at Charles in the absence of agreements like those at C.S. & Co. or Future Foam. The Tax Court in comparing C.S. & Co. with Charles, Inc., states:

> [T]he percentages of net income which were paid as compensation for officers of Charles, Inc., were 22.61%, 28.10% and 33.55% for the fiscal years ended June 30, 1966, 1967 and 1968, respectively. By comparison, C.S. & Co. paid 89.21%, 77.69% and 67.53% of its net income to officers as compensation for services during those same years. Because the two businesses were quite similar in operation, size, sales and net profits during the years in issue, we can only attribute the wide discrepancy in compensation to a distribution of profits by C.S. & Co. in the guise of salaries.

Taxpayers have introduced some evidence to support their contention that the compensation paid executive officers is reasonable. Such evidence is largely by way of conclusion. It is not disputed that all recipients of compensation here involved were competent and put in long hours of work and that the success of the taxpayer corporations was attributable to their efforts.

Taxpayers contend that the expert evidence they introduced to the effect that the compensation paid executives was reasonable is undisputed. We disagree. Internal Revenue Agent Johnson, who had served as a revenue agent since 1955 and had examined many corporate returns, testified that the compensation paid the executives here involved was excessive and set out in detail his reasons for such conclusion.

In any event, the Tax Court as a fact finder is the exclusive judge of the credibility of witnesses and the weight to be given their restimony, *Riss, supra,* at 166; *Investers Diversified Services, Inc. v. Commissioner,* 325 F. 2d 341, 351 (8th Cir. 1963); *Midland Ford Tractor v. Commissioner,* 277 F. 2d 111, 115 (8th Cir. 1960).

An element reflecting on the intent of the parties as to the potential effect of these agreements is the fact that the bylaws of these corporations were amended shortly after the agreements were adopted to require the employees to repay to the companies amounts which they received under the agreements but which were later declared by a court not to be deductible expenses for tax purposes. See Article VIII, Amendment to Bylaws, Charles Schneider & Co., adopted June 22, 1963. This may reflect a pre-existing knowledge on the part of the taxpayers that the payments would not be reasonable for tax purposes, and could lead to an inference as to their intent.

No purpose will be served in further detailing the extensive evidence. A careful examination of the record satisfies us that the Tax Court's decision is based on substantial evidence, that it is not induced by any erroneous view of the law, and that it is not clearly erroneous.

The decision of the Tax Court is affirmed.

A true copy.

Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

APPENDIX B

Opinion of the United States Tax Court

T. C. Memo. 1973-130

UNITED STATES TAX COURT

CHARLES SCHNEIDER & CO., INC., an Iowa Corporation, ET AL.,[1] Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 7740-70, 7741-70, 7743-70, 7744-70, 7745-70

Filed June 18, 1973.

1. Based on all the facts presented, compensation paid by the petitioners to certain officers was unreasonable and excessive. *Held:* Reasonable compensation determined.

2. Petitioner Future Foam, a corporation, purchased stock in a corporation which it hoped would serve as a distributor for its inventory. Future Foam later sold the stock without gain or loss but evidenced by a note. Several years after the sale, and without any payment, the note became worthless. *Held:* Future Foam is entitled to an ordinary bad debt loss pursuant to section 166(a).

3. Charles, Inc. and its wholly owned subsidiary Chemical Corporation of America filed a consolidated return for the

[1] Proceedings of the following petitioners are consolidated herewith: Future Foam, Inc., a Nebraska Corporation, docket No. 7741-70; Charles, Inc., an Iowa Corporation, docket Nos. 7743-70, 7744-70; Central Woodworking Co., Inc., an Iowa Corporation, docket No. 7745-70.

fiscal year ended June 30, 1968. The outstanding stock of Charles, Inc. was held entirely by Future Foam. *Held:* Charles, Inc. and Chemical Corporation of America were not privileged to file a consolidated return since Future Foam, a member of the affiliated group and parent corporation to Charles, Inc., did not join in such consolidation as required by section 1504(a) and section 1.1502-76(b)(1), Income Tax Regs.

Truman Clare and *R. David Garber,* for the petitioners.

Ronald M. Frykberg,, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

STERRETT, *Judge:* The Commissioner determined deficiencies in the petitioners' Federal income tax as follows:

Petitioner	Docket No.	Fiscal Year	Deficiency
Charles Schneider & Co., Inc.	7740-70	6/30/66	$31,396.22
		6/30/67	23,157.41
		6/30/68	29,178.81
Future Foam, Inc.	7741-70	8/31/66	34,930.17
		8/31/67	5,874.46
		8/31/68	22,725.58
Charles, Inc.	7743-70	6/30/67	1,864.38
	7744-70	6/30/68	11,664.58
Central Woodworking Co., Inc.	7745-70	6/30/66	492.80
		6/30/67	172.82
		6/30/68	344.77

Concessions have been made by the parties leaving the following three issues for our consideration:

(1) Whether the respondent erred in determining that certain deductions, claimed on the income tax returns of Charles Schneider & Co., Inc., Future Foam, Inc., and Central

Woodworking Co., Inc., for compensation of its executive officers, were unreasonable and excessive.

(2) Whether Future Foam, Inc. is entitled to a ousiness bad debt deduction, pursuant to section 166, of $30,000 upon the worthlessness of a note issued to Future Foam, Inc. in exchange for stock.

(3) Whether Charles, Inc. and its wholly owned subsidiary Chemical Corporation were privileged to file a consolidated return for the fiscal year ended June 30, 1968, without Future Foam, Inc., Charles, Inc.'s parent.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts, together with the exhibits attached thereto, are incorporated herein by this reference.

Petitioner Charles Schneider & Co., Inc. (hereinafter C.S. & Co.) is a corporation organized under the laws of Iowa with its principal office at Council Bluffs, Iowa. C.S. & Co. filed its Federal corporate income tax returns for the fiscal years ended June 30, 1966, June 30, 1967 and June 30, 1968 with the district director of internal revenue at Des Moines, Iowa.

Petitioner, Central Woodworking Co., Inc. (hereinafter Central) is a corporation organized under the laws of Iowa with its principal office at Council Bluffs, Iowa. Central filed its Federal corporate income tax returns for the fiscal years ended June 30, 1966, June 30, 1967 and June 30, 1968 with the district director of internal revenue at Des Moines, Iowa.

Petitioner Future Foam, Inc. (hereinafter Future Foam) is a corporation organized under the laws of Nebraska with its principal office at Council Bluffs, Iowa. Future Foam filed its Federal corporate income tax returns for the fiscal years ended August 31, 1966, August 31, 1967, and August 31, 1968 with the district director of internal revenue at Des Moines, Iowa.

Petitioner Charles, Inc. is a corporation organized under the laws of Iowa with its principal office at Council Bluffs, Iowa. Charles, Inc. filed its Federal corporate income tax returns for the fiscal years ended June 30, 1967 and June 30, 1968 with the district director of internal revenue at Des Moines, Iowa. Charles, Inc. filed an amended return for the fiscal year ended June 30, 1968 with the district director of internal revenue at Kansas City, Missouri.

Charles Schneider (hereinafter referred to as Schneider) was born in 1916. He had attended law school and completed all of his law school training, except pleading and practice, when he was called into military service during World War II. In 1946 Schneider started a furniture upholstering business in Omaha, Nebraska. Some 19 or 20 years later Schneider's business was moved to Council Bluffs, Iowa. On January 1, 1954, Schneider transferred the assets and liabilities of his proprietorship, which had been doing business as Charles Schneider and Company, to the petitioner, C.S. & Co., in exchange for its capital stock of $31,160.15. Schneider has owned all the issued and outstanding capital stock of C.S. & Co. since its incorporation.

During the period from January 1, 1954 to June 30, 1963, Schneider was the president of C.S. & Co. and Leon Summer

(hereinafter Summer) was the vice-president. Since July 1, 1963, Summer has been president. During all the years in issue, Schneider has been vice-president, treasurer, and chairman of the board of directors.

Summer, who was born in 1925, is a brother-in-law of Schneider. Summer, a Phi Beta Kappa graduate of the City College of New York, worked for C.S. & Co. for about 6 months during 1948. He then returned to New York for a period of time to do graduate work in economics at Columbia University.

After incorporation and through June 1958, Schneider, Summer and Rebecca Schneider, Schneider's mother, comprised the board of directors of C.S. & Co. From July 1958 to the date of trial the board of directors has been composed of Schneider, Summer and Truman Clare, the company's attorney.

Prior to 1954, Schneider and Summer founded a copartnership known as Central Woodworking Company. On January 1, 1954, Schneider and Summer transferred the assets and liabilities of their co-partnership to Central in exchange for its capital stock of $25,000. Schneider and Summer have each owned 50 percent of Central's outstanding stock since its incorporation.

Throughout its life Central has been principally engaged in the manufacture of wooden furniture frames. The bulk of Central's sales were to C.S. & Co. and Charles, Inc.

From Central's inception as a corporation through 1968, Summer was president and Schneider was vice-president.

Following incorporation through June, 1958, Schneider, Summer and Rebecca Schneider comprised the board of directors of Central. Since July, 1958, Schneider, Summer and Truman Clare have been the board members.

Charles Jobbing Company, Inc. was organized during September, 1958. Ten shares of the company's stock, par value $100 each, were issued to Schneider. On May 31, 1960 Charles Jobbing Company, Inc. changed its name to Future Foam. From incorporation through July 1, 1963, the board of directors consisted of Schneider, Summer and Truman Clare. During this same period Schneider held the office of president, and Summer was vice-president.

During the period from September, 1958 to July 1, 1963, Future Foam was doing business both under the name Charles Jobbing, as a wholesale jobber of fabrics, materials, and foam products, and under the name Chairs, Unlimited, as a manufacturer of chairs under a subcontracting arrangement with C.S. & Co.

Sol Friedman (hereinafter Friedman) was born September 26, 1935. He began working for C.S. & Co. in late 1958 or early 1959 on a part-time basis while attending the University of Omaha. Upon graduation in 1959 with a bachelor of science degree in business administration he began full-time employment with C.S. & Co. Friedman and Schneider are related through marriage. During 1960 Friedman became an employee of Future Foam.

Bill Grassman was born on January 3, 1933. He began working with the Future Foam Division of C.S. & Co. on a

part-time basis while attending the University of Omaha. Upon graduation from college as a chemistry major in June, 1958, he went to work on a full-time basis with the Future Foam Division of C.S. & Co.

While attending the University of Omaha and thereafter while employed by C.S. & Co. Grassman began working with Schneider and Dr. G. N. Marquardt of the University of Omaha Chemistry department to develop a polyurethane foam production process for use in making a cushioning material for upholstered furniture. Together they were able to develop a continuous production of polyurethane foam, a process which eluded many other companies' manufacturing polyurethane foam and which was more economical than prior methods.

On June 30, 1963, the Future Foam Division of C.S. & Co. was transferred to Future Foam. In connection therewith Future Foam received the following:

Cash	$ 6,080.25	
Accounts Receivable	211,944.71	
Machinery & Equipment -Net	23,949.26	
Inventories	31,774.20	
Accounts Payable		$252,293.96
Accrued Taxes		1,903.49
Retained Earnings		19,550.97
	$273,748.42	$273,748.42

Thereafter Future Foam commenced operations as a manufacturer of polyurethane foam products. Friedman became the president of Future Foam on July 1, 1963, and has held that office since that date. Grassman became an employee of Future Foam on July 1, 1963, and has been vice-president of the company since then. The board of directors since July 1,

1963 has been composed of Friedman, Grassman, and Schneider.

Charles, Inc. was incorporated on July 1, 1963. On the same day Future Foam, in an exchange for stock, spun off its Charles Jobbing and Chairs Unlimited operations to Charles, Inc., transferring the following to Charles, Inc.

Fixed Assets — Net	$ 930.10	
Accounts Receivable	35,956.76	
Cash	609.82	
Total Assets	$37,496.68	
Liabilities Assumed by Charles, Inc.:		
Iowa Withholding Taxes	$ 68.34	
Payroll Taxes	2,208.57	
Accrued Expenses	2,256.14	4,533,05
		$32,963.63

In the exchange Future Foam received the entire outstanding capital stock of Charles, Inc. in the amount of $32,963.63, which Future Foam has owned since that time. The president of Charles, Inc. since its incorporation has been Schneider. The board of directors through 1968 had been comprised of Schneider, Summer and Friedman.

On July 1, 1963, Schneider and Summer entered into written salary agreements with C.S. & Co. covering July 1, 1963 through June 30, 1968. The agreements provided that Schneider would receive a salary of $230 per week and that Summer would receive $351 per week. The agreements also provided for certain bonuses to be paid to Schneider and Summer. Though not spelled out in the agreements, the parties understood that the bonuses would be computed as follows:

Bonus No. 1.

If there was sufficient net income

Three-fourths of 1% of annual net sales divided equally between Schneider and Summer.

Bonus No. 2.

After deductions from net profits for:

(a) Schneider's and Summer's salaries and No. 1 bonuses.

(b) 2% of net sales for retained earnings;

(c) federal income taxes;

remainder to be divided equally between Schneider and Summer.

Schneider's agreement provided that his total compensation from C.S. & Co. could not exceed $65,000. Summer's agreement contained a stock option giving him the right to purchase up to 20 percent of C.S. & Co. stock. Summer failed to exercise this option.

The following table shows the compensation paid by C.S. & Co. to Schneider and Summer during the years in issue (not including deferred compensation):

6/30/66	Salary	Bonus #1	Bonus #2	Total
Schneider	$12,000.04	$4,876.84	$48,228.06	$65,104.94
Summer	19,305.00	4,876.84	50,232.66	74,414.50
6/30/67				
Schneider	12,000.04	5,949.63	41,103.31	59,052.98
Summer	19,305.00	5,949.63	41,103.32	66,357.95
6/30/68				
Schneider	12,000.04	8,367.19	44,632.77	65,000.00
Summer	19,305.00	8,367.19	46,417.17	74,089.36

The following table shows pertinent figures from C.S. & Co.'s income tax returns for the years ended June 30, 1954 through June 30, 1968 (figures rounded off to nearest dollar):

Year Ending	Gross Receipts	Gross Profit	Net Profit Before Officers' Salaries & Fed. Inc. Tax	Officers' Salaries Direct				Taxable Income	Federal Income Taxes	Net Profit After Officers' Salaries & Fed. Inc. Tax	Total Assets Book Value Year End	Earned Surplus Year End
				Charles Schneider	Leon Summer	Others	Total					
6/30/54	$ 320,107	$ 50,871	$ 16,779	$ 6,000	$ 5,000	$	$ 11,000	$ 5,779	$ 1,734	$ 4,045	$113,107	$ 4,045
6/30/55	836,476	137,141	28,488	12,000	10,000		22,000	6,488	1,946	4,541	124,630	8,587
6/30/56	949,384	174,793	45,112	12,791	11,520		24,312	20,800	6,240	14,560	134,927	23,147
6/30/57	863,533	172,308	38,400	12,701	11,769		24,470	14,015	4,205	9,811	159,138	32,958
6/30/58	1,269,777	284,017	75,171	25,285	13,984		39,269	35,902	13,169	22,733	217,935	55,691
6/30/59	1,977,683	439,178	88,001	40,470	17,391		57,861	30,140	10,533	19,607	375,058	75,298
6/30/60	2,428,921	548,517	88,100	44,059	19,556		63,616	24,485	7,345	17,139	497,829	89,280
6/30/61	2,599,173	537,532	105,893	43,357	18,571		61,928	43,964	17,361	26,603	456,088	112,726
6/30/62	2,675,104	549,122	78,622	42,612	18,603		61,215	17,407	5,222	12,185	511,328	121,754
6/30/63	2,546,219	398,376	83,537	43,416	18,954		62,370	1,167	350	817	592,827	119,414
6/30/64	1,009,255	260,071	43,215	14,570	21,083		35,654	7,561	1,733	5,829	378,512	102,008
6/30/65	1,110,292	351,118	96,528	31,496	38,329		69,825	26,704	7,835	18,869	340,026	134,225
6/30/66	1,300,490	455,382	182,466	65,105	74,414	23,229	162,748	19,717	5,002	14,715	363,099	148,558
6/30/67	1,586,567	546,967	206,716	59,053	65,358	34,469	159,880	46,835	15,834	31,001	476,333	180,079
6/30/68	2,231,249	725,240	254,658	65,000	74,089	31,860	170,950	83,708	36,996	46,712	686,586	225,548

Among the heading "Officers' Salaries — Others" in the above chart were the following:

Year	Officer	Compensation
6 30 66	Robert Conger	$13,460.00
	Raymond Trumble	9,769.01
6 30 67	Robert Conger	21,350.00
	Raymond Trumble	13,119.26
6 30 68	Robert Conger	28,690.00
	E. Tinley, III	3,170.19

C.S. & Co. returns for the years ended June 30, 1960 through June 30, 1968 indicate the company had the following number of employees at the end of each year.:

Year	Number of Employees
6 30 60	124
6 30 61	159
6 30 62	152
6 30 63	132
6 30 64	73
6 30 65	74
6 30 66	76
6 30 67	76
6 30 68	114

Prior to July 1963 Schneider and Summer, as president and vice-president, respectively, were the only officers actively involved with the management of C.S. and Co. Following July 1, 1963 and throughout the years in issue, Schneider was chief executive of Charles, Inc. and was less directly involved with the operations of C.S. & Co. The management team of C.S. & Co. during the years after July 1, 1963, was composed of Summer as president, Robert Conger, Joseph Inzaurro, Daniel Maschka, and Raymond Trumble. Conger, vice-president from 1966 forward, was a key man involved in many

facets of C.S. & Co.'s operations. Schneider's involvement was limited to creation of an atmosphere which would foster self-motivation of C.S. & Co.'s management team. Schneider was remarkably successful in this and thus played an important role in C.S. & Co.'s success.

Conger, Inzaurro, Maschka and Trumble were provided bonuses which were determined without relation to any set formula at year's end.

C.S. & Co. has not paid any dividends since its incorporation.

On July 1, 1963, Schneider, Friedman and Grassman entered into written salary agreements with Future Foam, which were in effect throughout the years in issue. Schneider's base salary was $150 per week. Friedman and Grassman were to receive $175 each. In addition the agreements provided for certain bonuses to be paid the three of them, computed as follows:

Bonus No. 1.

If there was sufficient net income

three-fourths of 1% of annual net sales divided equally between Friedman and Grassman.

Bonus No. 2.

After deductions from net profits for:

(a) salaries to Schneider, Friedman and Grassman and the number 1 bonus;

(b) 2% of net sales for retained earnings;

(c) federal income taxes;

(d) state income taxes;

remainder to be divided equally between Schneider, Friedman and Grassman.

Schneider's agreement provided that his total annual compensation would not exceed $65,000. Friedman's and Grassman's agreements contained provisions for each of them to purchase up to 20 percent of Future Foam. The agreements also provided that Friedman and Grassman would have no interest in Future Foam's stock investment in its wholly owned subsidiary, Charles, Inc., but that the net stockholder's equity in Charles, Inc. would accrue to Schneider.

Concurrently with the stock option grant, on July 1, 1963, Schneider, Friedman and Grassman entered into an agreement providing that upon the death of Friedman or Grassman, or their desire to sell or transfer their stock, the remaining shareholders would have first option to acquire the stock.

Between February 15, 1965 and August 31, 1965, Friedman and Grassman exercised their options. Throughout the years in issue of the total outstanding shares of Future Foam, Schneider owned 60 percent and Friedman and Grassman each owned 20 percent.

At a special meeting of the board of directors of Future Foam held on November 5, 1965, Schneider's maximum salary was reduced to $45,000 per year, for the fiscal year beginning September 1, 1965.

The following amounts were paid to Schneider, Friedman and Grassman for the fiscal year ended August 31, 1966:

	Salary	Bonus #1	Bonus #2	Total
Friedman	$13,520	$4,849	$61,807	$80,176
Grassman	13,520	4,849	61,807	80,176
Schneider	7,800		37,200	45,000

Had there not been a $45,000 limitation on Schneider's salary, he would have received $69,606 from Future Foam for the fiscal year ended August 31, 1966. However, the $24,606 excess was paid to Schneider during the following fiscal year, giving Schneider a total salary of $45,780 for the fiscal year ended August 31, 1967.

The following table shows pertinent figures from Future Foam's income tax returns for the years ended August 31, 1959 through August 31, 1968 (rounded off to nearest dollar):

Year Ending	Gross Receipts	Gross Profit	Net Profit Before Officers' Salaries & Fed. Inc. Tax	Officers' Salaries — Direct*					Taxable Income	Federal Income Taxes	Net Profit After Officers' Salaries & Fed. Inc. Tax	Total Assets Book Value Year End	Earned Surplus Year End
				Charles Schneider	Leon Summer	Sol Friedman	William Grossman	Total					
8/31/59	$ 111,433	$ 22,743	$ 19,698	$ 5,572	$2,786	$	$	$ 8,357	$11,341	$ 3,402	$ 7,939	$ 23,983	$ 7,939
8/31/60	290,307	125,085	34,693	10,312	5,156			15,468	19,225	5,768	13,458	110,821	21,396
8/31/61	553,357	136,080	34,445	10,080	5,040			15,120	19,325	5,798	13,528	112,066	32,453
8/31/62	858,354	140,305	20,875	10,600	5,300			15,900	4,975	1,493	3,483	165,894	33,905
8/31/63	1,202,313	79,726	15,771	10,275	3,000			13,275	2,496	749	1,748	289,769	51,143
8/31/64	903,520	164,493	74,529	6,023		21,512	21,512	49,047	25,482	7,411	18,071	262,483	54,584
8/31/65	1,209,983	366,429	238,017	60,117		70,399	70,399	200,916	37,101	12,798	24,303	391,387	78,507
8/31/66	1,293,131	386,476	265,995	45,000		80,176	80,176	205,352	60,643	23,756	36,887	457,620	114,195
8/31/67	1,328,123	303,476	125,883	45,780		31,874	31,874	109,528	16,355	4,519	11,836	458,222	125,348
8/31/68	1,610,338	380,351	132,064	19,086		30,845	30,845	80,776	51,288	20,681	30,607	455,237	155,959

* On Future Foam's returns for fiscal 1964 through 1968 officers' bonuses were deducted as part of cost of goods sold rather than as officers' compensation. The gross profit figures are prior to deduction of these bonuses and the bonuses are shown as part of officers' compensation.

The number of Future Foam employees at the end of each fiscal year ranged between 14 and 28 employees.

Future Foam's customers included C.S. & Co. and Charles, Inc. However, Future Foam sold foam to many other furniture manufacturers and C.S. & Co. and Charles, Inc. purchased foam from other producers.

Friedman was primarily involved with sales and administration within Future Foam. Grassman was charged with the production of the foam. Schneider was involved with company policy, corporate goals, and the development of Friedman and Grassman as a "self-motivated" management team.

Future Foam has not paid any dividends since its incorporation.

Schneider and Sumemr have each owned 50 percent of Central's stock since its incorporation on January 1, 1954. During the years ended June 30, 1960 through June 30, 1963, Summer, as president and Schneider as vice-president were each paid $8,060. During the years ended June 30, 1964 through June 30, 1966, each received $7,440. During the years ended June 30, 1967 and June 30, 1968, each received $5,340 and $2,400 respectively.

Central has not paid any dividends since its incorporation.

Charles, Inc. is a manufacturer of upholstered furniture doing business in direct competition with C.S. & Co. Charles, Inc.'s reputation in the industry as a furniture manufacturer

was equal to that of C.S. & Co. Some of Charles, Inc.'s line of furniture, while of the same general type, is slightly higher priced.

Schneider was the chief executive officer of Charles, Inc. during the years 1963 through 1968. During that time he was actively involved with the management and operations of the company. Again Schneider was interested in developing a strong self-motivated management team.

Prior to March 1966 Charles, Inc.'s management team was composed of Schneider, James Smyth (hereinafter Smyth), and Fred Ostrow. Schneider, Smyth and Ostrow were paid direct compensation of $13,113.68, $9,177.58 and $8,958.55 respectively for the year ended June 30, 1966.

Jack Shurter (hereinafter Shurter), a C.P.A., was hired by Charles, Inc. on March 1, 1966, to work as treasurer and comptroller. Shurter signed a salary agreement covering March 1, 1966 through June 30, 1971, in which Charles, Inc. agreed to pay him an annual salary of $13,000 plus a bonus payable from net profits computed as follows:

(1) 3½% bonus on the first $50,000.00 of said net profit.

(2) 4% bonus on said net profit of the corporation which is in excess of $50,000.00, but not more than $100,000.00.

(3) 4½% bonus on said net profit of the corporation which is in excess of $100,000.00, but not more than $150,000.00.

(4) 5% bonus on said net profit of the corporation which is in excess of $150,000.00, but not more than $200,000.00.

(5) 5½% bonus on said net profit of the corporation which is in excess of $200,000.00, but not more than $250,000.00.

(6) 6% bonus on said net profit of the corporation which is in excess of $250,000.00, but not more than $300,000.00.

Shurter played an active role in the management team of Charles, Inc. until he resigned effective June 15, 1968. Under his salary agreement, Shurter received $17,482.22 and $22,008.91 for the years ended June 30, 1967 and June 30, 1968 respectively.

Smyth, as vice-president of Charles, Inc., entered into a salary agreement with Charles, Inc. on July 1, 1966. For the period July 1, 1966 through June 30, 1971 Smyth was to receive an annual salary of $13,000 and a bonus computed in the same manner of Shurter. Schneider relied most heavily on Smyth and together they made Charles, Inc. a success. For the fiscal years ended June 30, 1967 and June 30, 1968, Smyth received $21,037.22 and $27,996.82 respectively.

Ostrow also received a similar bonus. His total compensation for the years ended June 30, 1967 and June 30, 1968 was $18,672.38 and $23,971.82 respectively. Ostrow was a part of the Charles, Inc. management team, but on a level below Schneider and Smyth.

Schneider did not have a bonus arrangement with Charles, Inc. He received direct compensation of $13,750 and $17,751.80 for the years ended June 30, 1967 and June 30, 1968 respectively.

The following table shows pertinent figures from Charles, Inc.'s tax returns for the fiscal years ended June 30, 1964 through June 30, 1968 (rounded to nearest dollar):

Year Ended	Gross Receipts	Gross Profit	Net Profit Before Officers' Salaries & Fed.Inc.Tax	Officers' Salaries - Direct[4] Charles Schneider	James Smyth	Jack Shurter	Fred Ostrow	Total	Taxable Income	Federal Income Taxes	Net Profit After Officers' Salaries & Fed.Inc.Tax	Total Assets Year End	Net Worth Year End
6-30-64	$ 379,138	$ 73,708	$ 14,434	$13,260				$13,260	$ 1,174	$ 336	$ 838	$ 76,421	$ 838
6-30-65	706,048	152,798	14,415	13,901				13,901	514	None	514	100,909	1,352
6-30-66	1,140,053	274,483	59,844	13,114				13,114	48,730	16,838	29,902	308,505	31,254
6-30-67	1,748,328	494,377	193,308	13,750	$21,037	$17,482		52,269	141,038	62,657	78,381	316,300	109,634
6-30-68	2,294,183	731,025	282,763	17,752	27,997	32,009	$23,972	91,730	191,034	89,433	101,601	479,154	210,660

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4 Only officers' salaries shown in the officers' compensation section of the tax return are reflected in the table.

Charles, Inc. had the following number of employees at the end of each of the following years:

Year Ended	Number of Employees
6/30/64	63
6/30/65	53
6/30/66	71
6/30/67	77
6/30/68	111

The factory buildings occupied by C.S. & Co., Future Foam, and Charles, Inc. were leased from Cynthia Realty Co. (hereinafter Cynthia Realty), a company having Schneider as its president and sole stockholder.

During 1966 Schneider, as president of Cynthia Realty, was involved in securing contractors for the construction of new factory buildings, and was thereafter paid a commission of $1,380.

C.S. & Co.'s net income, expressed as a percentage of gross profit, for each of its years ended June 30, 1966, 1967, and 1968 was 4.33%, 8.56% and 11.54% respectively. Charles, Inc.'s net income, expressed as a percentage of gross profit, for each of its years ended June 30, 1966, 1967 and 1968 was 17.02%, 28.52% and 26.13% respectively.

C.S. & Co. paid officers' compensation (including deferred compensation), expressed as a percentage of net income before federal income tax and before officers' salaries, as follows:

Year Ended	Schneider	Summer	Others	Total
6/30/66	35.73%	40.75%	12.74%	89.21%
6/30/67	28.55	32.10	17.03	77.69
6/30/68	25.60	29.19	12.74	67.53

Future Foam paid officers' compensation (including deferred compensation), expressed as a percentage of net income before federal income tax and before officers' salaries, as follows:

Year Ended	Friedman	Grassman	Schneider	Total
6 30 66	30.12%	30.14%	17.04%	77.30%
6 30 67	25.31	25.35	36.46	87.12

Charles, Inc. paid officers' compensation (including deferred compensation), expressed as a percentage of net income before federal income tax and before officers' salaries, as follows:

Year Ended	Schneider	Smyth	Shurter	Ostrow	Total
6 30 66	22.61%				22.61%
6 30 67	7.84	11.11%	9.15%		28.10
6 30 68	6.86	10.17	7.88	8.64%	33.55

During the years ended June 30, 1966, 1967, and 1968 (August 31, in the case of Future Foam) Schneider was paid direct and deferred compensation as follows:

	1966		
	Direct	Deferred	Total Compensation
C.S. & Co.	$65,104.94	$213.88	$ 65,318.82
Central	7,440.00	286.29	7,726.29
Future Foam	45,000.00	535.93	45,535.93
Charles, Inc.	13,113.68	541.64	13,655.32
			$132,236.36

	1967		
	Direct	Deferred	Total Compensation
C.S. & Co.	$59,052.98	$ 872.62	$ 59,925.60
Central	5,340.00	510.98	5,850.98
Future Foam	45,780.00	528.84	46,308.84
Charles, Inc.	13,750.00	1,626.29	15,376.29
			$127,461.71

	1968		
	Direct	Deferred	Total Compensation
C.S. & Co.	$65,000.00	$ 980.12	$ 65,980.12
Central	2,400.00	538.69	2,938.69
Future Foam	19,086.00	541.50	19,627.50
Charles, Inc.	17,751.80	1,979.35	19,731.15
			$108,277.46

During the years ended June 30, 1966, 1967 and 1968, Summer was paid direct and deferred compensation as follows:

	1966		Total
	Direct	Deferred	Compensation
C.S. & Co.	$74,414.50	$ 80.95	$74,495.45
Central	7,440.00	132.05	7,572.05
			$82,067.50

	1967		Total
	Direct	Deferred	Compensation
C.S. & Co.	$66,357.95	$1,013.11	$67,371.06
Central	5,340.00	272.78	5,612.78
			$72,983.84

	1968		Total
	Direct	Deferred	Compensation
C.S. & Co.	$74,089.36	$1,165.00	$75,254.36
Central	2,400.00	302.75	2,702.75
			$77,957.11

During the fiscal year ended August 31, 1966, Friedman was paid direct and deferred compensation as follows:

	Direct	Deferred	Total
Future Foam	$80,176.00	$290.39	$80,466.39

During the fiscal year ended August 31, 1966, Grassman was paid direct and deferred compensation as follows:

	Direct	Deferred	Total
Future Foam	$80,176.00	$331.53	$80,507.53

The respondent disallowed the amounts of direct compensation paid by C.S. & Co. to Schneider and Summer during its fiscal years ended June 30, 1966 through 1968 in excess of $35,000 and $50,000 respectively.

The respondent disallowed the amount of direct compensation paid by Central to Schneider during its fiscal year ended June 30, 1966, in excess of $5,200.

The respondent disallowed the amounts of direct compensation paid to Friedman and Grassman by Future Foam during the year ended August 31, 1966, in excess of $50,000 each. The respondent also disallowed the amounts of direct compensation paid to Schneider by Future Foam during its fiscal years ended August 31, 1966, and August 31, 1967 in excess of $35,000 a year.

The respondent did not dispute the compensation paid to any employee of Charles, Inc.

Prior to October 1, 1966, Future Foam had been selling foam products to Middle West Fabric Supply Co., Inc. a Missouri corporation (hereinafter referred to as Middle West), which had its principal place of business in the Kansas City, Missouri area. In order to have a constant sales source in the Kansas City area, Future Foam felt it needed the services of Middle West as a distributor of its foam products.

The minutes of the combined special meeting of the Board of Directors and Stockholders of Future Foam on October 15, 1966 stated the following:

> The chairman then stated that the primary purpose for holding this meeting was to discuss the investment by the corporation in 50% stock ownership of a Middle West Fabric & Supply Company, Inc., a Missouri corporation the office of which is located in Kansas City, Missouri. There was a general discussion of the purpose for the

acquisition of this stock as an investment. There were several good business purposes for the acquisition of this stock, and it was considered to be of mutual advantage both to Future Foam, Inc., and to the above named Missouri corporation for Future Foam, Inc. to acquire this stock. There was a review of the proposed agreement between the two above named corporations, as well as the stockholders agreement, and salary agreement between the above Missouri corporation and its President, Michael J. Levine. It was stressed that the acquisition of this stock by Future Foam, Inc. was not in any way to hinder its sale of products to other companies in the market area of the Missouri corporation, and that in general, each of the above corporations should deal with one another at "arms length" so far as buying, selling, or otherwise transacting business with one another.

Effective October 1, 1966 Future Foam agreed with Middle West to purchase 30,000 newly issued shares of Middle West stock, which would then equal 50 percent of all the issued and outstanding stock of Middle West for $30,000. The remaining 30,000 shares were owned by Michael J. Levine (hereinafter Levine), the president of Middle West. Upon acquisition of the Middle West stock, Friedman became Middle West's vice-president and secretary and also a member of its board of directors.

Of the $30,000 capital contribution made by Future Foam, approximately $5,000 to $8,000 immediately went into the purchase of equipment necessary in processing foam. Upon its contribution Future Foam debited its investment account in the amount of $30,000. The amount was reflected on Future Foam's balance sheets under the category "Other Investments."

Middle West continued to purchase foam from Future

Foam on a regular basis. Middle West soon began to have difficulty in paying its debts to Future Foam.

On October 1, 1967, Future Foam transferred the 30,000 shares of Middle West stock to Levine in exchange for a promissory note from Levine and his wife in the amount of $30,000, payable in monthly installments of $1,660. The first installment was not due until October 1, 1969. On November 6, 1967, Friedman resigned as vice-president, secretary and director of Middle West.

On May 28, 1968, Middle West informed Future Foam that due to continuing losses in its operation, it was ceasing operations and would be unable to pay its accounts due Future Foam. Thereafter the $30,000 Middle West stock investment was written off as a "Bad debt from Investment."

On November 12, 1968, Involuntary petitions in Bankruptcy were filed by Future Foam against Levine and his wife Barbara.

On its return for the year ended August 31, 1968, Future Foam claimed a bad debt deduction of $64,995. The respondent disallowed this to the extent of $30,000 which the respondent claimed was a capital loss.

Charles, Inc. filed a consolidated income tax return for its year ended June 30, 1968 with its wholly owned subsidiary, Chemical Corporation of America, Inc., which was organized on July 19, 1967. Future Foam, 100 percent owner of Charles, Inc. did not join in this consolidation.

OPINION

Section 162(a) provides that in computing its taxable income a corporation shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." The first issue we must decide is whether the amounts paid as compensation by C.S. & Co., Future Foam, and Central to their officers were reasonable within the meaning of section 162(a)(1).

The determination of the Commissioner is presumptively correct and the burden of proving the reasonableness of the compensation is upon the petitioners. *Botany Worsted Mills v. United States*, 278 U.S. 282 (1929). This is a question of fact to be ascertained from all the facts and circumstances of the particular case, *Anthony Mennuto*, 56 T.C. 910 (1971); *Boyle Fuel Co.*, 53 T.C. 162 (1969). As stated in *Mayson Manufacturing Co. v. Commissioner*, 178 F. 2d 115, 119 (C.A. 6, 1949), reversing a memorandum decision of this Court:

> Such factors include the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with the gross income and the net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; the salary policy of the taxpayer as to all employees; and in the case of small corporations with a limited number of officers the amount of compensation paid to the particular employee in previous years.

Where the employees, to whom the salaries are paid, are in control of the corporate employers's affairs, such circumstances are subject to close scrutiny by the Court, *Heil Beauty Supplies, Inc. v. Commissioner*, 199 F. 2d 193 (C.A. 8, 1952), affirming a memorandum decision of this Court; *Anthony Mennuto, supra.*

With respect to petitioner C.S. & Co. the respondent has questioned the reasonableness of salaries paid to Schneider and Summer in excess of $35,000 and $50,000, respectively, for the fiscal years ended June 30, 1966, 1967 and 1968. Throughout the years in question, Schneider owned 100 percent of all outstanding C.S. & Co. stock. Summer, Schneider's brother-in-law, was president.

On July 1, 1963, Schneider stepped down as president of C.S. & Co. to become president of the newly formed Charles, Inc. In this capacity, he devoted substantially less time to C.S. & Co. than before. He also held offices in Future Foam, Central and Cynthia Realty. Schneider's duties at C.S. & Co. became more advisory in nature and were directed primarily at creating an environment where the new management team, headed by Summer, would become entirely "self-motivated." Because of Schneider's decrease in responsibilities and services rendered to C.S. & Co., we must weigh the part-time nature of his duties in determining the reasonableness of his salary, *Ben Perlmutter*, 44 T.C. 382 (1965), affd. 373 F. 2d 45 (C.A. 10, 1967), see *Rota-Cone Oil Field Operating Co. v. Commissioner*, 171 F. 2d 219 (C.A. 10, 1948, affirming a memorandum decision of this Court.

In the years prior to 1963, Schneider as president of C.S. & Co. never made over $44,059. Yet in 1966, 1967 and 1968,

when Schneider was a part-time advisor and C.S. & Co. had an almost independent management team, his salary rose to $65,105, $59,053 and $65,000, respectively. This was in addition to the salaries he was drawing from other related corporations.

Schneider was admittedly a man of superior drive and qualifications. However, most of his innovations were already in use at C.S. & Co. and he had fewer responsibilities. See *Harolds Club v. Commissioner*, 340 F. 2d 861 (C.A. 9, 1965), affirming a memorandum decision of this Court. Deductions are allowable only to the extent that they represent compensation for services rather than distributions of profits, *Jefferson Block & Supply Co.*, 59 T.C. 625 (1973); *Paula Construction Co.*, 58 T.C. 1055 (1972), on appeal (C.A. 5, Nov. 13, 1973).

Summer, though president of C.S. & Co. during the years in issue, devoted a portion of his time to the management of Central. Thus we must consider his salary at C.S. & Co. in light of his other responsibilities. Summer was well qualified and expended a great deal of effort at C.S. & Co. Furthermore, though granted an option to purchase 20 percent of C.S. & Co. stock, he declined to do so.

In reviewing the compensation of both Summer and Schneider, we have been concerned by their bonus agreements with C.S. & Co. whereby all net profits are divided equally by Summer and Schneider after setting aside 2 percent of net sales for retained earnings and amounts for state and federal taxes. Such contingent payments need close and careful consideration, *Tumwater Lumber Mills Co. v. Commissioner*, 65 F. 2d 675 (C.A. 9, 1933), affirming a memorandum decision of this Court.

The following table shows the compensation paid by C.S. & Co. to Schneider and Summer during the years in issue (not including deferred compensation):

Year Ended	Salary	Bonus #1	Bonus #2	Total
6/30/66				
Schneider	$12,000.04	$4,876.84	$48,228.06	$65,104.94
Summer	19,305.00	4,876.84	50,232.66	74,414.50
6/30/67				
Schneider	12,000.04	5,949.63	41,103.31	59,052.98
Summer	19,305.00	5,949.63	41,103.32	66,357.95
6/30/68				
Schneider	12,000.04	8,367.19	44,632.77	65,000.00
Summer	19,305.00	8,367.19	46,417.17	74,089.36

The effect of Bonus #2 appears to us to be a built-in mechanism for the distribution of profits and is apparently without relation to services performed, *R. H. Oswald Co., Inc. v. Commissioner*, 185 F. 2d 6 (C.A. 7, 1950), affirming a memorandum decision of this Court; *Klamath Medical Service Bureau*, 29 T.C. 339 (1957), affd. 261 F. 2d 842 (C.A. 9, 1958). C.S. & Co. indicates that the bonus agreement provided a "high risk" incentive to Schneider and Summer. In view of Schneider's 100 percent ownership of stock we find that such incentive could have been of little value to him, *Irby Construction Co. v. United States*, 290 F. 2d 824 (Ct. Cl., 1961); *City Chevrolet Co. v. Commissioner*, 228 F. 2d 894 (C.A. 4, 1956), affirming a memorandum decision of this Court. Summer was related to Schneider.

Other members of the post-1963 C.S. & Co. management team did not have similar bonus arrangements. Robert Conger, who Summer classified as a key man with great responsibility

in the operations of C.S. & Co., was promoted to vice-president in 1966 and was paid $23,460, $21,350 and $28,690 during the fiscal years ended June 30, 1966, 1967 and 1968. This indicates to us that aside from Schneider and Summer, C.S. & Co. did not feel that "high risk" incentives were necessary to secure the desired performance from management personnel.

The respondent has not questioned the reasonableness of salaries paid by Charles, Inc. Schneider devoted the greatest portion of his time to the management of Charles, Inc. Its management team was made up of Schneider, president, James Smyth, vice-president, Jack Shurter treasurer, and Fred Ostrow, vice-president from 1968 forward. This management team did not have bonus arrangements similar to those given Schneider and Summer by C.S. & Co. Smyth, Shurter, and Ostrow did have salary agreements which provided bonuses ranging from 3½ percent to 6½ percent of net profits in addition to a base salary. Smyth, the highest paid member of this management team, never made more than $28,000 during the years in issue. Furthermore, the percentages of net income which were paid as compensation for officers of Charles, Inc. were 22.61%, 28.10% and 33.55% for the fiscal years ended June 30, 1966, 1967 and 1968, respectively. By comparison, C.S. & Co. paid 89.21%, 77.69% and 67.53% of its net income to officers as compensation for services during those same years. Because the two businesses were quite similar in operation, size, sales, and net profits during the years in issue, we can only attribute the wide discrepancy in compensation to a distribution of profits by C,S. & Co. in the guise of salaries.

That some profits were distributed is further shown by a failure of C.S. & Co. to pay dividends, though a profitable

corporation since its inception in 1954. *The Barton-Gillet Co. v. Commissioner*, 442 F. 2d 1343 (C.A. 4, 1971), affirming per curiam a memorandum decision of this Court; *Charles McCandless Tile Service v. United States*, 422 F. 2d 1336 (Ct. Cl., 1970). Where a corporation has a large capital investment, shareholders are entitled to a return on their contributions. *Pacific Grains, Inc. v. Commissioner*, 339 F. 2d 603 (C.A. 9, 1968), affirming a memorandum decision of this Court. We doubt seriously whether salary agreements such as those before us would be permitted by completely independent shareholders.

Taking into account both sides of the coin, for example the obvious superior talents of Schneider and Summer yet the excessively high percentage of net income paid out in salaries, and admitting the uncertainties in substituting our business judgment for that of others, we find that salaries paid by C.S. & Co. to Schneider and Summer, during each of its fiscal years 1966, 1967 and 1968, in excess of $40,000 and $60,000, respectively, to be unreasonable and hence not allowable as deductions.

Future Foam during the years in issue was owned 60 percent by Schneider, 20 percent by Friedman and 20 percent by Grassman. Most of our reasoning for C.S. & Co. has applicability to Future Foam. Schneider was involved with several other corporations, primarily Charles, Inc. The part-time nature of his services lessen his overall value to the corporation. Moreover, Schneider, Friedman and Grassman had bonus agreements similar to the C.S. & Co. bonus previously discussed, providing the even division of net profits among the three officers after deleting 2 percent of net sales for retained earnings and amounts covering state and federal taxes.

This agreement resulted in 77.3 percent of net income (prior to deducting officers' compensation and state and federal taxes) being used to pay Schneider, Friedman, and Grassman. Schneider's salary was limited to a maximum of $45,000. However, excess 1966 bonus of $24,606 was merely paid over to Schneider the following year. Future Foam has also never paid any dividends.

Again, taking all factors into consideration, we find that the salaries paid Schneider by Future Foam during its fiscal years 1966 and 1967 in excess of $40,000 to be unreasonable in amount and hence nondeductible. With respect to Friedman and Grassman we find amounts paid out by Future Foam in fiscal year 1966 in excess of $65,000 to be excessive and hence unallowable as a deduction.

Central was owned equally by Schneider and Summer. Summer, as president, devoted more time to the management of Central than Schneider during the fiscal year ended June 30, 1966. Schneider and Summer were paid identical sums of $7,440 during the year in issue. Central has never paid any dividends. The Commissioner determined that any salary given to Schneider in excess of $5,200 was unreasonable. In view of Schneider's unusual leadership ability we find nothing unreasonable about a salary to him of $7,440 and so hold.

In our holdings we have looked to many factors, some of which we have stated in our opinion, and others self-evident from our findings of fact. We have based our conclusion on the services rendered to each petitioner separately by the various employees involved. See *Salem Packing Co.*, 56 T.C. 131 (1971).

The second issue we must face is whether Future Foam is entitled to a deduction as a bad debt pursuant to section 166(a) or whether it has sustained a capital loss on the worthlessness of a note it acquired on the sale of stock it held in another corporation.

In order to secure a reliable distributor of its foam products, Future Foam purchased 50 percent of the stock of Middle West at a cost of $30,000. After a relatively short period of time, Middle West had difficulty in paying its accounts due Future Foam. As a result of this undesirable situation, Future Foam sold its stock to Levine, the only other shareholder of Middle West, for its original cost of $30,000. The $30,000 was evidenced by a note between Levine and his wife and Future Foam. During the fiscal year ended August 31, 1968, prior to any payments by Levine, the note became totally worthless.

Because wer are convinced that the Middle West stock was purchased in the ordinary course of Future Foam's business of manufacturing and selling foam, we would have had no doubt that it would have been entitled to an ordinary loss deduction under section 165(a), had the loss occurred on the sale of the stock, *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955); *Schlumberger Technology Corp. v. United States*, 443 F. 2d 1115 (C.A. 5, 1971); *Electrical Fittings Corp.*, 33 T.C. 1026 (1960). The fact that the petitioner, Future Foam, carried it on its books as an investment, or made reference to it as such, does not alter our conclusion, *Corn Products Refining Co., supra; Tulane Hardwood Lumber Co., Inc.*, 24 T.C. 1146 (1955).

However the loss occurred on the worthlessness of the note rather than on the sale of the stock. For this reason we are

governed by the provisions of section 166. See *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934). Section 166(a)(1) grants a deduction for any debt which becomes worthless within the taxable year. We hold that Future Foam is entitled to ordinary deduction pursuant to section 166(a)(1) on the worthlessness of Levine's note, especially in light of the ordinary nature of the entire transaction. Furthermore respondent's attempt to distinguish business vs. nonbusiness bad debts pursuant to section 166(d) is completely erroneous since it specifically excludes corporate taxpayers from its operation.

The last issue we must decide is whether Charles, Inc. and its wholly owned subsidiary, Chemical Corp. of America were entitled to file a consolidated return without Future Foam, the parent of Charles, Inc.

Section 1501 provides that an affiliated group of corporations shall have the privilege of filing a consolidated return if all members of the affiliated group consent to all the consolidated regulations prescribed under section 1502. Section 1504 defines an "affiliated group" to mean "one or more chains of includible corporations connected through stock ownership with a common parent corporation," if certain 80 percent stock ownership requirements, not in issue herein, are met.

Section 1.1502-76(b)(1) Income Tax Regs. provides that "The consolidated return of a group must include the income of the common parent for that corporation's entire taxable year * * * and, except as provided in subparagraph (5) of this paragraph [not relevant herein], the income of each subsidiary for the portion of such taxable year during which it was a

member of the group." The consolidated return regulations are legislative in character and have the force and effect of law. *Salem Packing Co., supra,* at 144.

Since the incorporation of Charles, Inc. on July 1, 1963, the entire outstanding capital stock of Charles, Inc. has been held by Future Foam. Chemical Corporation of America, Inc. was the wholly owned subsidiary of Charles, Inc. It is therefore apparent to us that Charles, Inc. and Chemical Corporation of America were not privileged to file a consolidated return without having Future Foam, the common parent and a necessary corporation in the affiliated chain join in such consolidated return.

The petitioners argue that Future Foam is not the parent of Charles, Inc. because beneficial title to 100 percent of the stock lies with Schneider. The only evidence we have supporting the petitioners' position is the salary agreements executed between Future Foam and Friedman and Grassman. In granting Friedman an option to purchase 20 percent of Future Foam's stock the agreement stated:

> There is presently issued and outstanding ten (10) shares of the common stock of the company, par value, $1,000.00, owned solely by Charles Schneider. The parties contemplate that an additional $18,000.00 of common stock represented by one hundred eighty (180) shares of the capital stock of the company, shall be issued to Charles Schneider on or about September 1, 1963. *It is also contemplated that Sol [Friedman] shall have no interest in the stock investment to be made by Future Foam, Inc., in its wholly owned subsidiary, Chairs, Inc., [predecessor of Charles, Inc.] but that the net stockholder's equity in such investment shall accrue to Charles Schneider.*

It is quite evident that Future Foam was a viable corporate entity with an existence apart from its shareholders. *Moline Properties, Inc. v. Commissioner,* 319 U.S. 436 (1943); *David F. Bolger,* 59 T.C. 760 (1973), cf. *William B. Howell,* 57 T.C. 546 (1972). Furthermore, it has not been established to our satisfaction that Future Foam held the Charles, Inc. stock merely as an agent for Schneider, *National Carbide Corporation v. Commissioner,* 336 U.S. 422 (1949). Admittedly, Schneider would have practical control over Charles, Inc. However we do not think that this is sufficient to say that Future Foam has given up its right to vote the Charles, Inc. stock and carry out other functions incident to being a shareholder. Future Foam was therefore a member of an affiliated group, including Charles, Inc. and Chemical Corporation of America. Since Future Foam did not join in filing a consolidated return with the other members of the group, the regulations have not been followed. Therefore we hold that the income, cost of goods sold, and various other expenses of Chemical Corporation of America may not be used by Charles, Inc. in determining its taxable income for the fiscal year ended June 30, 1968.

Decisions will be entered under Rule 50.

APPENDIX C-1

Sec. 162 [1954 Code]. (a) In General. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including —

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State congressional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

APPENDIX C-2

§1.162-7. Compensation for personal services. — (a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for

personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate.

Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In the event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder. [Reg. §1.162-7.]

APPENDIX C-3

Rule 52. Findings by the Court

(a) Effect. In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which

constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).